

STATE OF MINNESOTA
OFFICE OF ADMINISTRATIVE HEARINGS
FOR THE MINNESOTA DEPARTMENT OF REVENUE

In the Matter of Proposed Repeal
of Rule Governing Constitutional
Exemptions, Minn. Rules part 8310.4900.

REPORT OF THE
ADMINISTRATIVE LAW JUDGE

The above-entitled matter came on for hearing before Administrative Law Judge George A. Beck at 9:00 a.m. on May 23, 1996, at the Minnesota Department of Revenue, 10 River Park Plaza, St. Paul, Minnesota. The hearing continued until all interested persons had been heard.

This Report is part of a rulemaking proceeding held pursuant to Minn. Stat. §§ 14.131 to 14.20, to hear public comment, to determine whether the Minnesota Department of Revenue (the Department) has fulfilled all relevant substantive and procedural requirements of law applicable to the adoption of the rules, whether the proposed rules are needed and reasonable and whether or not any modifications to the rules proposed by the Department after initial publication are substantially different.

The Department's hearing panel consisted of Thomas J. Seidl, Supervising Attorney, Linda Geier, Staff Attorney, and Michael Haeg, Law Clerk. Fifteen persons attended the hearing. Eight persons signed the hearing register. The hearing continued until all interested persons, groups or associations had an opportunity to be heard concerning the adoption of these rules.

The record remained open for the submission of written comments for twenty calendar days following the hearing, to June 12, 1996. Pursuant to Minn. Stat. § 14.15, subd. 1, five working days were allowed for the filing of responsive comments. At the close of business on June 19, 1996 the rulemaking record closed for all purposes. The Administrative Law Judge received written comments from interested persons during the comment period. The Department submitted written comments responding to matters discussed in written comments and at the hearing.

NOTICE

This Report must be available for review to all affected individuals upon request for at least five working days before the agency takes any further action on the rule(s). The agency may then adopt a final rule or modify or withdraw its proposed rule. If the Commissioner of the Department of Revenue makes changes in the rule other than those recommended in this report, he must submit the rule with the complete hearing

record to the Chief Administrative Law Judge for a review of the changes prior to final adoption. Upon adoption of a final rule, the agency must submit it to the Revisor of Statutes for a review of the form of the rule. The agency must also give notice to all persons who requested to be informed when the rule is adopted and filed with the Secretary of State.

When the Commissioner files the rules with the Secretary of State, he shall give notice on the day of filing to all persons who requested that they be informed of the filing.

Based upon all the testimony, exhibits, and written comments, the Administrative Law Judge makes the following:

FINDINGS OF FACT

Procedural Requirements

1. On March 28, 1996, the Department mailed the Notice of Hearing to all persons and associations who had registered their names with the Department for the purpose of receiving such notice and to the persons who appear on the list of additional persons to receive the Notice of Hearing.

2. On April 22, 1996, the Notice of Hearing and the proposed rules were published at 20 State Register 2288. [\[1\]](#)

3. At the hearing, the Department filed the following documents with the Administrative Law Judge:

- (a) the Notice of Solicitation of Outside Opinion published at 20 State Register 354, on August 21, 1995;
- (b) a copy of the proposed rules certified by the Revisor of Statutes;
- (c) the Statement of Need and Reasonableness (SONAR);
- (d) a copy of the Notification to the Legislative Commission to Review Administrative Rules;
- (e) a copy of the Notice of Hearing as mailed to persons on the Department's mailing list;
- (f) a copy of the State Register pages containing the Notice of Hearing and its proposed rules;
- (g) the Certification of Mailing the Notice to all persons on the Board's mailing list;
- (h) the Certification of Additional Mailing; and,

- (l) all the comments that the Department has received concerning the proposed rules.

State's Exhibits 1-9.

Task Force on Proposed Rule.

4. No advisory task force was formed to assist the Department in formulating the repeal.

Statutory Authority.

5. In its SONAR, the Department cites Minn. Stat. § 270.06(14), which generally authorizes the Commissioner to make rules for the administration of the tax laws of the State, as its statutory authority to repeal the rule. The statutory authority was not challenged. The Judge concludes that the Department has the general statutory authority to repeal the proposed rule.

Cost and Alternative Assessments in SONAR.

6. Minn. Stat. § 14.131 provides that state agencies proposing rules must identify classes of persons affected by the rule, including those incurring costs and those reaping benefits; the probable effect upon state agencies and state revenues; whether less costly or less intrusive means exist for achieving the rule's goals; what alternatives were considered and the reasons why any such alternatives were not chosen; the costs that will be incurred complying with the rule; and differences between the proposed rules and existing federal regulations.

7. In its SONAR, the Department concluded that there will be no costs or benefits associated with the repeal of the rule since the underlying federal law will remain in effect. The Department stated it considered the possibility of amending the rule (subpart 3 in particular) to again attempt an accurate interpretation, but dismissed the idea due to what it perceives as past failures to achieve an accurate interpretation. It also concluded that there is no difference between state and federal law if the rule is repealed since federal law will be given deference. One commenter stated that there was an obvious benefit to the Department in terms of a litigation advantage and a corresponding "cost" to pipeline companies. While that may be true, those regulated by the rule do not experience increased costs of compliance due to its repeal; in this instance the Department is proposing less regulation, which should not increase costs. Great Lakes also argues that the Department's SONAR is fatally flawed and argues that this rule proceeding should be terminated as a consequence. It argues that the Department's analysis that repeal of the rule will have no impact is simply inadequate since the lack of a verbalized standard will constitute a change. Great Lakes argues that the Legislature enacted the Chapter 14 provisions requiring a detailed impact analysis for a purpose, namely, to improve the analysis agencies must perform before adopting or repealing rules. It suggests that the Department has not complied with

this mandate. Ex. 7, p. 1-3. Since Great Lakes raised this argument in its final submission, the Department had no opportunity to respond specifically.

8. The Administrative Law Judge finds that the Department has met the requirements of Minn. Stat. § 14.131 relating to cost and alternative assessments. The parties in this rulemaking proceeding are sophisticated in their knowledge of the rulemaking process. While the Department's analysis might have been more expansive, it is adequate given the nature of this proceeding, including the fact that this is a proposed repeal of a rule rather than the proposed adoption of a rule. No interested party has been denied the opportunity to participate meaningfully in this rulemaking proceeding due to the Department's SONAR. While agencies are expected to comply with SONAR requirements in good faith, there is no provision in the APA which specifically makes the degree of compliance or other inadequacies in a SONAR grounds for terminating a rule proceeding. Rather the Legislature has required that an analysis be made as to whether any failure deprived a person of the opportunity to meaningfully participate. In this case, even if the Department's analysis could be termed error, it is a harmless error within the meaning of Minn. Stat. § 14.15, subd. 5. All of the parties participating were well aware of the Department's reasoning and potential arguments, pro and con.

Impact on Farming Operations

9. Minn. Stat. § 14.111 (1996), imposes an additional notice requirement when rules are proposed that affect farming operations. The proposed rules will not affect farming operations and no additional notice is required.

Nature of the Proposed Rule

10. In this rulemaking proceeding, the Department seeks to repeal Minn. Rule pt. 8130.4900. This rule is an explanation of the types of transactions that are exempt from Minnesota sales and use taxation due to the mandates of the United States Constitution. Subpart 2 lists federal agencies which are exempt from state taxation under the doctrine of intergovernmental immunity. Subpart 3, which drew most of the attention in this rulemaking proceeding, attempts to state when the commerce clause of the federal constitution precludes the imposition of a sales or use tax by the state of Minnesota. Subpart 4 states that the federal due process clause prohibits Minnesota from taxing the sale or use of personal property occurring outside of the state of Minnesota. Subpart 5 states an exemption for the sale or use of tangible personal property sold to foreign counselor officers, their employees or members of their families. Subpart 6 recites exemption from sales and use tax for purchases made by federal credit unions. Subpart 7 indicates that sales of tangible personal property are taxable services by the federal government are subject to tax. This rule was first adopted in 1974, but was modified and added to in 1993.

Analysis of the Proposed Rules

11. Under Minn. Stat. § 14.14, subd. 2, and Minn. Rule 1400.2100, one of the determinations which must be made in a rulemaking proceeding is whether the agency has established the need for and reasonableness of the proposed rule or rule repeal by an affirmative presentation of facts. An agency need not always present adjudicative or trial-type facts in support of a rule. The agency may rely on legislative facts, namely general facts concerning questions of law, policy and discretion, or it may simply rely on interpretation of a statute, or stated policy preferences. Manufactured Housing Institute v. Pettersen, 347 N.W.2d 238, 244 (Minn. 1984); Mammenga v. Department of Human Services, 442 N.W.2d 786 (Minn. 1989). Under Minn. Stat. § 14.02, subd. 4, the repeal of a rule is subject to the same APA requirements as the adoption of a new rule. It has been held at the federal level that an agency must present a "reasoned analysis" for its change of course in repealing a rule when it comes to a different conclusion. Motor Vehicle Manufacturers Association v. State Farm Mutual, 463 U.S. 29 (1983). The Department prepared a Statement of Need and Reasonableness ("SONAR") in support of the repeal of the rule. At the hearing, the Department primarily relied upon the SONAR as its affirmative presentation of need and reasonableness for the repeal. The SONAR was supplemented by the comments made by the Department at the public hearing and in its written post-hearing comments.

12. The question of whether a rule has been shown to be reasonable focuses on whether it has been shown to have a rational basis, or whether it is arbitrary, based upon the rulemaking record. Minnesota case law has equated an unreasonable rule with an arbitrary rule. In re Hanson, 275 N.W.2d 790 (Minn. 1978); Hurley v. Chaffee, 231 Minn. 362, 367, 43 N.W.2d 281, 284 (1950). Arbitrary or unreasonable agency action is action without consideration and in disregard of the facts and circumstances of the case. Greenhill v. Bailey, 519 F.2d 5, 10 (8th Cir. 1975). A rule is generally found to be reasonable if it is rationally related to the end sought to be achieved by the governing statute. Mammenga v. Department of Human Services, 442 N.W.2d 786, 789-90 (Minn. 1989); Broen Memorial Home v. Minnesota Department of Human Services, 364 N.W.2d 436, 444 (Minn. Ct. App. 1985). The Minnesota Supreme Court has further defined the agency's burden in adopting rules by requiring it to "explain on what evidence it is relying and how the evidence connects rationally with the agency's choice of action to be taken." Manufactured Housing Institute, *supra*, 347 N.W.2d at 244. An agency is entitled to make choices between possible approaches as long as the choice it makes is rational. Generally, it is not the proper role of the Administrative Law Judge to determine which policy alternative presents the "best" approach since this would invade the policy-making discretion of the agency. The question is rather whether the choice made by the agency is one a rational person could have made. Federal Security Administrator v. Quaker Oats Company, 318 U.S. 2, 233 (1943).

13. In addition to need and reasonableness, the Administrative Law Judge must assess whether the rule adoption procedure was complied with, whether the rule grants undue discretion, whether the agency has statutory authority to adopt the rule, whether the rule is unconstitutional or illegal, whether the rule constitutes an

undue delegation of authority to another, or whether the proposed language is not a rule. Minn. Rule 1400.2100. This Report is generally limited to the discussion of the portions of the rule proposed for repeal that received significant critical comment or otherwise need to be examined. Because some sections of the proposed rule were not opposed and were adequately supported by the SONAR, a detailed discussion of each subpart of the rule is unnecessary. The Administrative Law Judge specifically finds that the Department has demonstrated the need for and reasonableness of the deletion of any provisions of the rule proposed be deleted that are not specifically discussed in this Report, that such deletion is specifically authorized by statute and there are no other problems that would prevent the deletion of the subparts.

14. Where changes are made to the rule after publication in the State Register, the Administrative Law Judge must determine if the new language is substantially different from that which was proposed originally. Minn. Stat. § 14.15, subd. 3 (1996). The standards to determine if the new language is substantially different are found in Minn. Stat. § 14.05, subd. 2 (1996). The Department did not propose any modification of what was published in the State Register.

15. **Minn. Rule pt. 8240.4900, subp. 2**, sets out examples of federal agencies which are exempt from state sales tax. Keith E. Carlson, Director of Tax Analysis for the Senate Tax Committee, objected to the deletion of this subpart because it is the only source of documentation as to what federal government entities fall under the exemption. Public Ex. 1. In response to this concern, the Department issued Revenue Notice No. 96-6 on May 27, 1996. Ex. 10. The Revenue Notice duplicates subpart 2, subpart 5, subpart 6 and subpart 7 of the existing rule. It does not include subpart 1, subpart 3 and subpart 4 of the existing rule. This action meets Mr. Carlson's concern.

16. Most of the comments were directed towards the Department's proposed repeal of **subpart 3** of this rule, which states as follows:

The commerce clause of the federal constitution precludes the imposition of a sales or use tax if the imposition of the tax unduly burdens interstate commerce.

17. In its Statement of Need and Reasonableness, the Department states as follows:

In 1983, subpart 3 of this rule was revised in order to exercise the widest scope of taxing authority consistent with the United States Supreme Court decision in Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977). However, some confusion has arisen over the current rule language, which prompted the department to re-examine the need for the rule. The department has concluded that the constitutional exemption provision in Minn. Stat. § 297A.25, subd. 4,

is adequate, by itself, to encompass ongoing developments in the Supreme Court's interpretation of the commerce clause. Minn. Rules, pt. 8130.4900, subp. 3, creates unnecessary confusion and should, therefore, be repealed.

State's Ex. 3.

18. Minn. Stat. § 297A.25, subd. 4, provides as follows:

The gross receipts from the sale of and the storage, use or other consumption in Minnesota of tangible personal property, tickets, or admissions, electricity, gas, or local exchange telephone service, which under the Constitution or laws of the United States or under the Constitution of Minnesota, the state of Minnesota is prohibited from taxing, are exempt.

19. The Northern Border Pipeline Company, which owns a natural gas pipeline which crosses Minnesota, opposed the repeal of subpart 3. It argued that while the "unduly burdens" test might not have the clarity of the four-pronged test enunciated by the Supreme Court in Complete Auto Transit, Inc. v. Brady, outright repeal of the rule would result in confusion and uncertainty for the taxpayer. It suggested that the Complete Auto Transit test be adopted as a replacement for the current subpart 3. Public Ex. 4. The Minnesota Chamber of Commerce also supported clarifying the rule rather than eliminating it. Public Ex. 5.

20. The Great Lakes Gas Transmission Limited Partnership and the Northern Natural Gas Company ("Great Lakes") filed comments which argued that the Department had failed to demonstrate either a need for or the reasonableness of the repeal of subpart 3. Great Lakes contends that the Department's reliance on the statute, Minn. Stat. § 297A.25, subd. 4, as adequate in itself, is mistaken since it provides no guidance, whereas the present rule does. Great Lakes also suggests that the impetus for the deletion of this rule is a dispute between the Department and the natural gas pipeline industry over whether the use tax applies to natural gas supplied to pipelines by their customers, and burned in compressor engines at the compressor stations in Minnesota that are required to keep the gas under enough pressure to keep it moving through the pipeline. The pipeline companies have alleged that they are exempt under subpart 3, and suggest that the Department seeks to delete this subpart in order to strengthen its position. Ex. 6, p. 4. Great Lakes notes that the 1993 amendment of this subpart was designed to more accurately track the holding in the Complete Auto Transit. Great Lakes argues that one instance of litigation over a 22-year period since the rule was first adopted does not constitute confusion. Great Lakes also argues that it is the Department's responsibility to provide guidance to taxpayers concerning its view on the impact of the commerce clause of the United States Constitution on Minnesota sales and use tax law. It asserts that the current rule at least gives every taxpayer a clear starting point from which to begin an analysis.

21. In its first post-hearing submission, the Department suggests that rulemaking is an inappropriate procedure for interpreting constitutional law which can change any time that there is a new decision in this area. It states that the Department has determined that the "unduly burdens" language does not accurately interpret the Complete Auto Transit case and only raises the question of when the imposition of taxes is unduly burdensome. Ex. 11, p. 2-3.

22. In its comment, the Department described the Complete Auto Transit test as follows:

For instance, subpart 3 of the rule, (the Commerce Clause restriction on state taxation), is an attempted reflection of the Supreme Court case (Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 97 S.Ct. 1076 (1977)). This case established a four-part test to determine when a state may impose taxation upon an interstate business. The test establishes that the taxing state must first, and most importantly, show that sufficient nexus exists before it may impose a tax. What constitutes sufficient nexus has been defined by the Court in National Bellas Hess, Inc. v. Dep't of Revenue, 386 U.S. 753, 87 S.Ct. 1389, 18 L.Ed.2d 505 (1967); Standard Pressed Steel v. Dep't of Revenue, 419 U.S. 560, 95 S.Ct. 706, 42 L.Ed.2d 719 (1975); Tyler Pipe Industries, Inc. v. Washington Department of Revenue, 483 U.S. 232, 107 S.Ct. 2810, 97 L.Ed.2d 199 (1987); and most recently in Quill Corp. v. North Dakota, 504 U.S. 298, 112 S.Ct. 1904, 119 L.Ed.2d 91 (1992). The Department proposes to provide direction in a case-by-case basis in this area through the use of Revenue Notices. It suggests that repeal of the rule will remove a form of misguidance, since the language of the rule inaccurately reflects the Supreme Court's standard.

The second part of the Complete Auto test, is that the tax must be fairly apportioned to the business conducted in the taxing state. The most recent guiding apportionment case is Container Corp. of America v. Franchise Tax Board, 463 U.S. 159, 103 S.Ct. 2933, 77 L.Ed.2d 545 (1983).

The third part of the Complete Auto test requires that the tax not discriminate against interstate commerce. In other words, the tax must be imposed upon similar intrastate businesses as well. There are no major cases on this point, as it is fairly self explanatory.

The final part of the test requires that the tax be fairly related to the services provided by the state. This requirement was restricted by the Supreme Court, to the point of being non-existent, in Commonwealth Edison Co. v. Montana, 453 U.S. 609, 101 S.Ct. 2946, 69 L.Ed.2d 884 (1981).

Ex. 11. The Department proposes to provide direction on a case-by-case basis in this area through the use of Revenue Notices. It suggests that repeal of the rule will remove a form of misguidance, since the language of the rule inaccurately reflects the Supreme Court's standard.

23. In response, Great Lakes pointed out that the Department has cited no appellate cases decided since 1993 (when the rule was amended) which would

cause a change in the "unduly burdens" standard. It suggests that the Department has simply become disenthused with the standard it adopted and wants to repeal it without admitting that its position is now different than what it was in 1993. Ex. 7, p. 5. It argues that there is no evidence of confusion or inaccuracy in the "unduly burdens" standards. Great Lakes also pointed out that since there has been a rule in effect since 1974, and since Supreme Court doctrine in this area moves slowly, it cannot be concluded that rulemaking is inappropriate for announcing the Department's interpretation of the constitutional standard.

24. In its final submission, the Department suggested that its contention that subpart 3 no longer reflects the current state of law was not seriously challenged. It points out that some commentators had suggested changing the language to reflect the current tests established by the Supreme Court, thereby admitting the present rule was inaccurate. It argues that it has discretion as to how to provide its interpretations to taxpayers, and that the use of Revenue Notices is more appropriate than administrative rulemaking. State's Ex. 13.

25. The question presented is whether or not the Department has shown that repeal of its rule is reasonable. Its main argument is that subpart 3 does not accurately interpret the case law as set out at Finding of Fact No. 22. While Great Lakes suggested that subpart 3 was a reasonable interpretation of the case law (T. p. 60), other commentators admitted that subpart 3 was unclear, but favored its replacement rather than repeal. (Public Ex. 4, 5). The Department admits that it made a mistake in 1993 in determining that the "unduly burdens" language accurately paraphrased and consolidated the holdings of the cases. It is theoretically possible that an agency might decide to repeal a rule because it came to a different conclusion based upon the prior rulemaking record alone, but the agency must justify its policy reversal. Motor Vehicle Manufacturer, *supra*. No analysis of Complete Auto Transit was presented by any commenter which would indicate that it is accurately incorporated into subpart 3. The explanation at Finding of Fact No. 22, on the other hand, suggests that the subpart does not accurately interpret the case law. Additionally, although Great Lakes suggests that the present rule provides some guidance beyond the statute, the Department's argument that it answers few questions since it requires a further analysis of what causes an undue burden, is persuasive.

26. The Department has made a reasoned analysis in support of its repeal and its change of course. It has explained on what evidence it is relying and how that evidence connects with its choice of action. Manufactured Housing Institute, *supra*. Whether or not this is the best approach in terms of providing guidance to taxpayers may be questioned, but it is not arbitrary based upon this rulemaking record. The fact that this proposed repeal arises from a litigation dispute is relevant, but is not determinative, if the Department has justified its action. The Department has justified its action by explaining the case law holdings, comparing them to the rule, and reasoning that the "unduly burden" test is not only inaccurate, but

potentially misleading. The Department can change its interpretation or position if it does so in a reasoned manner.

Based upon the foregoing Findings of Fact, the Administrative Law Judge makes the following:

CONCLUSIONS

1. The Minnesota Department of Revenue (the Department) gave proper notice of this rulemaking hearing.
2. The Department has substantially fulfilled the procedural requirements of Minn. Stat. §§ 14.14, subds. 1, 1a and 14.14, subd. 2, and all other procedural requirements of law or rule so as to allow it to repeal the proposed rule.
3. The Department has demonstrated its statutory authority to repeal the rule, and has fulfilled all other substantive requirements of law or rule within the meaning of Minn. Stat. §§ 14.05, subd. 1, and 14.50 (i) and (ii).
4. The Department has demonstrated the need for and reasonableness of the repeal of the rule by an affirmative presentation of facts in the record within the meaning of Minn. Stat. §§ 14.14, subd. 2 and 14.50 (iii).
5. The additions and amendments to the proposed rules which were suggested by the Department after publication of the proposed rules in the State Register do not result in rules which are substantially different from the proposed rules as published in the State Register within the meaning of Minn. Stat. § 14.15, subd. 3, and Minn. Rule 1400.2100C.
6. Any Findings which might properly be termed Conclusions are hereby adopted as such.
7. A finding or conclusion of need and reasonableness in regard to any particular rule subsection does not preclude and should not discourage the Department from further modification of the proposed rules based upon an examination of the public comments, provided that the resulting rule is not substantially different from the proposed rules as originally published, and provided that the rule finally adopted is based upon facts appearing in this rule hearing record.

Based upon the foregoing Conclusions, the Administrative Law Judge makes the following:

RECOMMENDATION

IT IS HEREBY RECOMMENDED that the rule be repealed.

Dated this 11th day of July, 1996.

GEORGE A. BECK
Administrative Law Judge

Reported: Taped

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^[1] The pages in this issue were inaccurately numbered by the State Register.